The Millennium Challenge Account: Making the Vision a Reality
Testimony for the House Committee on International Relations
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Two years ago before this committee, I testified that the MCA had the potential to significantly improve the quality and effectiveness of US foreign aid. The original concept of the MCA -- identify countries with a strong commitment to development, provide them with substantial funding for high priority activities to support economic growth and fight poverty, limit bureaucratic interference, and hold recipients accountable for results -- remains very promising as an innovative vehicle for the people of the United States to achieve some of our most important foreign policy goals. It provides the United States the opportunity to use our strength, stature and resources to show the world that we can lead the way in helping low-income countries provide economic opportunities, stimulate economic growth, and fight poverty.

The MCC has made important progress in several areas towards achieving that vision. It has established a lean organization that is taking seriously the ideas of country ownership and consultations in program design. It identified a reasonably strong set of countries to submit proposals for funding. And it is considering a wide range of substantive proposals to support poverty reduction and growth. In other areas, however, progress has been slow and is falling short of the original vision, particularly in terms of size and speed.

This next year is critical for the MCC, as the time has now come to take the bold steps necessary to turn its great potential into reality. The MCC faces six key challenges:

1. ***Scaling Up to the Original MCA Vision***
2. ***Balancing the Tensions Between the Consultative Process, Quality and Speed***
3. ***Firmly Establishing the Principle of Local Ownership***
4. ***Ensuring High Quality Programs***
5. ***Demanding Results while Encouraging Innovation***
6. ***Targeting the Right Countries***

The MCC must now move from its initial start-up phase to become a mature, strong, and professional organization that puts the United States at the forefront of innovative and effective development assistance. I believe that as the MCC takes the steps necessary to achieve that vision, it deserves our continued strong support.

The MCA's Promise and Potential

The MCA builds on America's core values of generosity, commitment to progress and poverty reduction, and the expectation of clear results. It operates on six key guiding principles that set it apart from most other foreign aid programs:

- It focuses clearly on promoting economic growth and poverty reduction, rather than supporting diplomatic and political partners or achieving other goals, which can be supported with other programs. The sharper focus and clearer goals should help ensure that both recipient countries and the American public get better outcomes.

- It selects a small number of recipient countries that have demonstrated a strong commitment to sound development policies, helping make aid funds more effective.
- It allows recipient countries to set priorities and design programs, engendering stronger commitment for success by recipients, and ensuring that programs actually are aimed at meeting the most urgent local needs.
- Its keeps its bureaucracy to a minimum, avoiding the large administrative structure and heavy regulation that bedevils some other aid programs.
- It is designed to provide recipients with sums of money large enough to make a real difference on the ground and provide strong incentives for success.
- In principle, it holds recipients much more accountable for achieving results, including being willing to increase funding for successful programs and reduce it for weaker programs.

Important Progress To Date

During its first year, the MCC has made important progress in several areas:

- *Establishing the organization.* The MCC has established itself from scratch in just over one year, working rapidly to hire key staff, open offices, and set up the basic functions of the Corporation. It moved as quickly as the legislation allowed to convene its Board of Directors, announce country selection methodology, and select MCA and Threshold countries for 2004 and 2005. Despite being short-staffed in the early period, it made efforts to visit eligible countries to inform them about the MCA and worked with USAID to establish the Threshold Program. It has now received proposals from 16 of 17 MCA-eligible countries and from all countries eligible for the Threshold Program.
- *Creating incentives for policy reform*. The MCA has garnered significant attention abroad, with many low-income countries expressing interest in participating in the program. According to the MCA, the incentives for policy reform are already at work. For example the median number of days to start a business fell from 63 in 2004 to 45 in 2005, in part due to the emphasis the MCC placed on this indicator. Moreover, the MCC sites several countries that have passed tough anti-corruption legislation in hopes of being considered for the MCA. These results must be interpreted with caution, however, because the median score for other indicators actually worsened from 2004 and 2005. For example, the medians for political rights and civil liberties both deteriorated from a score of 4 to 5 – more likely attributable to the inclusion of a wider pool of countries in 2005 than any incentive created by the MCA.
- *Negotiating and signing the first compact.* The signing of the first country compact 6 months after the initial proposal was submitted is an important milestone. This pace was appropriate, as it takes time to work with countries to set their own priorities and map out a set of programs that complements a national development strategy.
- *Adhering to a vision.* To some degree, the MCA has adhered to its vision of being more focused and more nimble than traditional aid programs. An important part of this is that the Congress has given the MCA greater flexibility and fewer directives, which should help increase innovation and effectiveness. The MCA's success will

rely partly on the freedom from pressure to contribute to strategic foreign policy goals beyond targeted poverty reduction and economic growth, and freedom from directives that obligate spending in certain sectors.

- *Promoting transparency*. The MCC is unique among US donor agencies in the amount of information easily available on its website. It is particularly notable that the MCC posts all of the data used to select eligible countries, opening itself to unusual scrutiny. The MCC has been partially successful in setting a standard for transparency among eligible countries as well. Of the 16 that have submitted compact proposals, half have made their proposals publicly available on national websites.
- *Engaging with the public.* The CEO and staff of the MCC have made themselves available to interested parties through outreach meetings, individual consultations, sessions with eligible-country embassies, and participation in NGO working group meetings. The MCC was receptive to suggestions that it change one of the selection criteria to include girls' primary school completion rates, and has opened for public participation the deliberation on an indicator for natural resource management.

Key Concerns and Challenges

Despite this early progress, the MCC faces several key challenges going forward if it is to achieve its full promise and potential. In its first year, the program, understandably, has experienced some growing pains. The next year will be critical for the organization to scale up its vision, increase its speed, and ensure high quality programs to support growth and poverty reduction.

Challenge #1: Scaling Up to the Original MCA Vision

The MCA provides a bold vision for how the people of the United States can support committed and dynamic governments in fighting poverty, creating economic opportunities, increasing growth, and improving the standard of living for some of the world's poorest people. For the MCA to really help committed governments transform their economies, it must (1) provide substantial funding to make a real difference on the ground, (2) provide strong incentives for countries to take the steps necessary to become eligible and implement strong, successful programs, and (3) hold countries accountable for results.

The President's original proposal called for $5 billion in funding each year, implying compacts that would be in the neighborhood of a minimum of $150-$200 million per year or more, making the MCC the largest donor in most countries. Countries would be willing to take the steps necessary to qualify, consult widely to design their own programs, and work hard to implement them successfully if they believed that substantial funding would be available with low bureaucratic costs, and that results would be rewarded. This would lay the foundation for the powerful combination of improved policies to become eligible, substantial funds to make a difference in people's lives, and the incentive to achieve results to enable continued funding.

At this early stage, however, it is not clear that the MCC is on track to achieve this vision. Its first compact in Madagascar calls for around $27 million per year, far smaller than the original vision, and just enough the make the MCC a slightly larger than average donor in the country. For the first 16 eligible countries, the MCC is currently reviewing proposals amounting to about $3 billion over 3-5 years – an average of about $40-60 million per country per year, depending on the length of the compact. This would make the MCC the third or fourth largest donor on average in the recipient countries. Programs of this size are only one-quarter to one-third of the original MCA vision, and as such are unlikely to be large enough to bring about significant change and create the incentives for improved performance. By contrast, aiming for compacts for 12 of the first 17 countries over four years of a size equal to the largest donor would require MCC commitments of about $5.5 billion, a far better target.[1]

The Corporation must encourage countries to be big, bold, and innovative in their proposals, and not discourage them from large proposals, as sometimes has been the case. For example, reportedly Armenia's original proposal amounted to $900 million, which has now been revised to $175 million. Madagascar's final compact left out several components that were in its original submission, and Mozambique was also asked to scale back. Of course, the MCC should not just encourage a wish list with a hodge-podge of activities, but it should envision interconnected programs of a scale that can make a significant impact on poverty reduction and economic growth. MCA eligible countries have among the most committed and capable governments, and have shown their ability to use aid flows effectively. Each has huge needs for improved infrastructure, water supply, power, health, education, and other areas where funds can be well used. The MCC has the opportunity to work with governments to provide funding on a large enough scale, always holding them accountable for results (as discussed below), to make substantial progress in the fight against poverty. But aiming to be a slightly larger-than-average donor won't accomplish that goal.

Challenge #2: Balancing the Tensions Between the Consultative Process, Quality and Speed

Many observers have expressed concern that it took so long for the MCC to sign its first compact with Madagascar. Much of the responsibility for the slow start lies with the administration, rather than the MCC, which did very little preparatory work during the two years between the President's speech proposing the MCC and the passage of the enabling legislation. There was a missed opportunity to prepare guidelines for recipient countries, analyze options for financial flows, and consider various models for monitoring and evaluation. This, however, is now water under the bridge.

The MCC literally started from scratch just over a year ago, and chose the first group of eligible countries in May 2004 at the earliest possible date. In my view, given this start, it is perfectly appropriate that the first compact was signed in April 2005, 11 months after

[1] Actual disbursements from the largest donor in each of the 17 MCA eligible countries in 2003 totaled $1.94 billion, or about $114 million per country. 12 compacts of four year duration at this size would require commitments of $5.5 billion.

country selection. One of the strengths of the MCA is that it relies on country-led proposals, which require time to develop options, consult with stakeholders, and design high-quality interventions. There is an important balance to be struck between, on the one hand, the natural desire for speed, and on the other hand, the importance of a country-led process and the need to ensure quality. Moreover, there are certain growing pains inherent in a new organization that is hiring staff and establishing all new procedures while at the same time working with countries on proposals.

However, while the amount of time to get from country selection to the first compact was acceptable, the more relevant concern is that *only one* compact has reached that stage. Just four others are in advanced negotiation, and some of these may take several months to finalize. The other 11 countries in the first round are well behind schedule. Ideally, after one year, the MCC should be close to making decisions – either up or down -- on all 16 of the first round countries, not just a few.

Currently the MCC works with countries after they submit their proposals in an attempt to strengthen programs. Since there are no deadlines, the process can continue for many months, sometimes with relatively little progress, without a clear decision on the proposal. An alternative that would help provide more certainty and speed the process would be to announce two Board dates each year during which decisions would be made on all submitted proposals. For example, the MCC could announce its country selections in October, and plan on Board meetings in early May and early September to decide on proposals. Deadlines for final proposal submission would be April 1 and July 15. This timing would provide countries more than 5 months to prepare their proposal for the first round, and close to 9 months for the second round, which should be ample time to conduct consultations, prepare a proposal, and receive some initial feedback from the MCC. In its May meeting, the Board would make firm decisions to either approve or disapprove all proposals submitted by the April deadline. Disapproved proposals could be revised and resubmitted in time for the September Board meeting.

These kinds of deadlines, which are common practice among many foundations, would help focus the attention of both recipients and MCC staff, speed the process, and provide certainty to the status of all countries. The MCC currently use such deadlines for its Threshold Program, but not for MCA eligible countries. At a broader level, the MCC should set a range of goals and deadlines for itself – some of them public, as its recipients do -- and measure its own progress against those targets

Challenge #3: Firmly Establishing the Principle of Local Ownership

The MCA's potential stems not only from its projected size, but because it promises to deliver aid differently and more effectively than many traditional aid programs. A key component is to give more responsibility and flexibility to recipient countries to establish priorities and design programs that can be tailored to local needs and circumstances. This is a very sensible approach, especially since MCA countries are chosen based on their demonstrated record of good governance and sound policy.

Both the administration and Congress, and especially the authorizing committees within Congress, deserve credit for this design. The administration refrained from placing too many directives on program content and formulation. Congressional authorizers wisely decided not to earmark funds for specific purposes, recognizing that local governments with proven records were better placed to determine the highest priorities. This process will greatly enhance local ownership, which in turn will increase commitment to success, improve program design, and increase effectiveness. As a result, each dollar of MCA funding is likely to have a larger impact on growth and poverty reduction.

Nevertheless, maintaining local ownership for priorities will be a challenge. Some observers believe, incorrectly, that for an MCC program to reduce poverty, it must always include investments in health and education. Others believe, equally incorrectly, that for a program to support growth, it must be aimed directly at finance and business. In fact, economic growth and poverty reduction are closely linked in most countries, with growth the strongest contributor to sustained poverty reduction. Sustained growth requires a combination of good governance, strong investments in health and education, and a robust private sector. In turn these three ingredients form the foundation of the most effective poverty reduction strategies. Of course the specific details and most appropriate combinations will vary across countries, which is why local ownership and direction is so important. The MCA need not fund all the ingredients of a strong growth and poverty reduction program, but rather should be aimed at filling gaps not met by local resources or other donors.

Supporters of the MCA cannot, on the one hand, call for stronger country ownership and, on the other hand, try to influence program content and effectively second-guess the priorities that eligible countries choose for their programs. Undue micro-management from afar will ultimately weaken the impact and effectiveness of MCA investments. At the same time, it is incumbent on the MCC to honor the country ownership process and not steer countries away from their stated priorities, as long as they are technically sound. This is particularly important in light of reports that the MCC has discouraged some countries from pursuing some stated priorities, especially in health and education, which can have a strong impact on both growth and poverty reduction. In the spirit of full transparency, the MCC must take steps to reassure Congress and the public that compacts actually represent country priorities. Towards this end, the MCC should publish guidelines for the consultative process, and more clearly and transparently describe the process it uses to judge the merits of initial proposals and the various components of proposals. As one part of this strategy, it should establish an independent technical review panel to help evaluate proposals, as described below.

Challenge #4: Ensuring High Quality Programs

<u>Technical Review.</u> The MCC is considering proposals covering a very wide range of substantive areas, including agricultural production, tourism, land titling, transportation, water, finance, energy, health, and education. The MCC's small staff does not have, and should not be expected to have, expertise in all of these areas. Yet it needs to make recommendations on the proposals, provide oversight, and conduct monitoring and

evaluation. To ensure high technical quality, it will need to rely on a combination of in-house expertise, staff from other executive branch agencies, and outside experts. The MCC is taking some steps in all three directions.

In addition, the MCC should consider establishing an independent Technical Review Panel of outside experts to evaluate all proposals prior to approval with respect to their technical merits and their potential contribution to poverty reduction and growth. The Panel would make non-binding recommendations to the Board. The panel should consist of non-partisan technical experts with deep knowledge of development that can provide expert opinion and commentary that will help strengthen proposals and assist the Board in distinguishing strong proposals from weak ones. The panel could combine a core set of members that would evaluate all proposals, together with additional specialists where necessary for certain proposals where the core panel may not have sufficient expertise.

Staffing. Both composition and size of the MCC staff are important. On composition, the MCC has placed a priority on hiring staff with fresh ideas from the private sector, complemented by professionals with government experience. This strategy has its strengths and to an extent should be encouraged, but it also has its limitations. In particular, while the current staff is a strong group of professionals with important skills, there appear to be relatively few with strong expertise in economic development, which could adversely affect program quality. While fresh outside perspectives are welcome, it is critically important to augment the current staff with experts in economic development and poverty reduction, along with experienced professionals with deep knowledge of the strengths and weaknesses of other donor approaches.

With respect to staff size, the MCC currently has about 120 staff members, and is planning to increase to 200 by the end of 2005. One of the key objectives of the MCC is to keep its bureaucracy and administration small, both to maximize the funds available to recipients and to ease the administrative burden on recipients. Aiming for a relatively small staff size is admirable. However, a staff of 200 is extremely small for an organization planning to disburse at least $2 billion per year or more in the near future. At this size, the ratio of dollars disbursed per staff member is about $10 million:1, a very high ratio. By comparison, the Ford Foundation disburses about $1 billion with a staff of 600, a ratio of about $1.6 million per staff member, the U.K.'s Department of International Development disburses about $3.3 billion with a staff of 2,200 ($1.5 million per staffer), and the International Finance Corporation disburses about $3.1 billion with a staff of 2,200 ($1.6 million per staffer). Very few organizations have a ratio as high as $4 million:1, much less $10 million:1.[2]

There is a real danger that the MCC's staff will be too small, which could significantly undermine efficiency and effectiveness in several ways. Too few staff would:

- Slow the speed of proposal review, negotiation, and disbursement. Whereas one compact has been signed and four are in negotiation, much less progress has been made on the other 12 countries, partly due to staff constraints in the first year.

[2] See Radelet (2003), Challenging Foreign Aid: A Policymakers Guide to the Millennium Challenge Account, page 114.

- Impede communication with other agencies, Congress, and recipient governments. Communication has clearly suffered in the first year because of staff shortages. For example, whereas staff prepared guidance for recipient countries for writing proposals, it has not yet released guidance for the consultative process, financial responsibilities and mechanism, monitoring and evaluation, and other key processes.
- Overburden staff with responsibilities outside their expertise, leading to frustration and high rates of burn-out.

This is not a call for a large bureaucracy with unnecessary administrative staff, but a modest increase to ensure efficiency and effectiveness. A staff of approximately 300, rather than the envisaged 200, would be more in line with the envisaged size of the MCC's disbursements, and would bring the ratio of disbursements to staff size more in line with the most efficient foundations and financial organizations. It would strike an appropriate balance between the need for sufficient professional competence and a lean administrative structure, keeping the MCC amongst the smallest of donor agencies. In particular, the MCC should aim to recruit a larger number of staff with strong backgrounds and experience in economic development and more specialists in the critical roles of monitoring and evaluation, as discussed below.

Challenge #5: Demanding Results while Encouraging Innovation and Risks

It is imperative that the MCC hold recipients accountable for achieving results. It should reward countries that achieve their targets with renewed funding, and reduce or eliminate funding for those that do not. A sound monitoring and evaluation (M&E) process is central to making the MCA highly effective in achieving results, in several ways:

- *Creating incentives.* Clearly rewarding success and penalizing failure will establish clear incentives for recipients to take all steps necessary to achieve specified goals. Without a strong M&E program, it will be impossible for the MCC to clearly distinguish successful programs.
- *Allocating resources*. A strong M&E program is essential to allocate more financial resources to successful programs, improving the impact of the program.
- *Keeping programs on track*. An effective M&E program can help detect problems at an early stage, and provide critical information to help countries get back on track. In this way, strong M&E programs help increase the probability of success by providing useful diagnostic information.
- *Learning what works and what does not*. A good M&E program will help distill the lessons from one program to improve the design of other programs. M&E programs help us learn what works, what doesn't work, and why.

Establishing a strong M&E program is complex. It requires skilled staff, adequate resources, the ability to acquire sound baseline data, and establishing appropriate, measurable goals. Unfortunately, most aid agencies substantially under-fund M&E, undermining the incentives for strong performance and limiting understanding about program effectiveness. It is too early to tell how successful the MCC will be in this regard, but one early sign raises a concern. Under current staffing plans the MCC is aiming for just 16 people in its M&E program, a woefully inadequate number. Staffing of this size threatens to repeat the mistake of other aid agencies that under-fund M&E. Far more skilled people will be needed in this critical area, supported by the financial resources needed to obtain the necessary data and carry out evaluations, if the MCC is to reach its promise of effective, results-based programs.

At the same time, sound judgment will be required to balance the need to penalize failure with the desire to encourage innovation and new ideas. Designing large scale, innovative programs will require time, patience, and some tolerance for risk. As with any investment banking or venture capital fund, not all MCC investments will pay large dividends, and we should all recognize up front that some will fail. But the risk of an occasional setback should not discourage the Corporation from aiming high, and should not detract from the potential for significant progress in many countries.

Challenge #6: Targeting the Right Countries

The Country Selection Process. More has been written and said about the MCA's country selection process than any other aspect of the program. In these discussions it is easy to get bogged down in the details, which are necessarily imperfect, and lose sight of the bigger picture and intended purpose. The selection methodology is designed to provide an objective, non-politicized process to distinguish countries that are committed to sound development policies that can use aid effectively from those countries that are not. As much as possible, the process relies on publicly available quantitative criteria rather than subjective back-room judgments. The problem, of course, is that no set of indicators can ever be perfect. The selection process for the MCC could be improved on the margin, but by-and-large it has succeeded in de-politicizing the allocation of aid funds and in providing a mechanism to hold accountable the MCC Board for its decisions. There are several ways in which the process could be strengthened, as I have described elsewhere.[3] But it should not be dramatically changed, nor should it be overloaded with many new indicators on topics unrelated to the MCC's core mission.

Eligibility of Lower-Middle Income Countries. Beginning in FY 2006, the MCC plans to add a second group of candidate countries consisting of all countries with per capita incomes between $1,465 and $3,035. The inclusion of these countries has always been controversial. They are much richer than the low income countries and have less need for foreign aid, since they have much larger private capital inflows, saving rates, and tax revenue. Generally, countries that reach this income level begin to "graduate" from aid and move to private sector finance. The counter-argument is that many of these countries have significant numbers of poor people that can effectively use MCC assistance. While this may be true, aid funds must be allocated to where they are most urgently needed, and the fact remains that most of the lower-middle income countries have several other alternative sources of finance to fund poverty reduction programs. Allocating funds away from the poorest countries (that have far fewer options) in favor of the richer countries is not the most optimal use of MCC funds.

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[3] Radelet (2003) Challenging Foreign Aid, and Steven Radelet and Sarah Lucas "An MCA Scorecard: Who Qualified, Who Did Not, and the MCC Board's use of Discretion," May 2004, www.cgdev.org/Publications/?PubID=118

Nevertheless, the MCC legislation states that the Corporation shall consider these countries as candidates for MCC assistance in 2006. The Board has the flexibility to determine which, if any, of these candidate countries will be eligible to submit proposals for assistance, and the authority to allocate from zero to up to 25% of appropriated funds for this set of countries.

These decisions were taken at a time when the administration and Congress were aiming to provide the MCC with $5 billion in FY 2006, the first year the lower-middle income countries would become candidates. Now that the administration has scaled back its request to $3 billion, the eligibility of these countries should be seriously reconsidered. With constrained budgets, and with many of the first year eligible countries not yet having reached the negotiation stage, the MCC should concentrate its efforts on the poorest countries and not expand to the middle income countries. The more limited funds available should be focused on the poorest countries. The size of the programs in the poorest countries should not be diluted by the addition of several lower-middle income countries to the list of eligible countries.

In considering the candidacy of these countries for 2006, the MCC Board should aim to make very few, if any, eligible to submit proposal during this start up phase. Ideally, at most one or two (if any) should be declared eligible, and the amount of funding available to them should be restricted so that they do not undermine the size of the programs in the poorer countries, where funding needs are more urgent. This part of the program could be gradually ramped up over time as funding and other constraints allow, so long as these richer countries do not detract funding from lower-income MCA eligible countries.